No. 21,185

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

JOAN E. HELLER TRUST (FORMERLY
JOAN E. SMOTKIN TRUST),
ARIZONA TRUST CO., TRUSTEE, et al.,

PETITIONERS,

vs.

THE COMMISSIONER OF INTERNAL
REVENUE,

RESPONDENT.

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

## BRIEF FOR THE PETITIONERS



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### OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court dated November 18, 1965, (R.[1] 89), is reported in T.C. Memo. 1965-302, and the supplemental memorandum findings of fact and opinion of the Tax Court dated June 6, 1966, (R. 112), is reported in T.C. Memo. 1966-121.

[1] Transcript of Record, filed July 18, 1966.

1. The following proceedings are consolidated herewith: CAROLE D. SMOTKIN TRUST, ARIZONA TRUST CO., TRUSTEE; ROBERT E. HELLER and JOAN E. HELLER, husband and wife; HAROLD J. SMOTKIN TRUST, ARIZONA TRUST CO., TRUSTEE; and EDWARD E. and BETTY J. SMOTKIN, husband and wife.

## JURISDICTION

The jurisdiction of this Court rests on Section 7482 of the Internal Revenue Code. Decision was entered by the Tax Court on March 18, 1966, determining deficiencies in Petitioners' Federal income tax returns for calendar years 1955, 1956 and 1957, in the total sum of $82,637.23, plus interest according to law, (R. 107-111). Petition for review by this Court was timely filed on June 13, 1966, (R. 116).

## QUESTIONS PRESENTED

1. Taxpayers determined during the years in issue to liquidate their investment in 194 duplexes which they had previously held exclusively for rental purposes. (a) Did the Tax Court err when it held that taxpayers at the time of such liquidation were holding the duplexes primarily for sale in the ordinary course of their trade or business? In selling the duplexes taxpayers, as part of the consideration, received the purchasers' second contracts. (b) Did the Tax Court err in determining that such contracts had an *ascertainable* fair market value? (c) Where the only evidence before the Tax Court was an expert witness's testimony that these contracts were not negotiable and would not freely and easily pass from hand to hand in commerce in Arizona, did the Tax Court err in determining these contracts had an ascertainable fair market value and that they

would be freely negotiable at a discount of 50% of face value?

## STATUTES INVOLVED

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include ——

> (1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND VOLUNTARY CONVERSIONS.

[ SEC. 1231(a) ]

(a) GENERAL RULE. —— If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business . . . exceed the recognized losses from such sales, exchanges and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. . . .

* * * * *

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle. ——

* * * * *

(3) LONG-TERM CAPITAL GAIN. —— The

term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months.

* * * * *

SEC. 1202. DEDUCTION FOR CAPITAL GAINS.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 per cent of the amount of such excess shall be a deduction from gross income. . . .

* * * * *

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS. —— The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such Section for determining loss over the amount realized.

(b) AMOUNT REALIZED. —— The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. . . .

* * * * *

Internal Revenue Code of 1954.

**STATEMENT**

The facts found by the Tax Court, and the stipula-

tion of the parties adopted by the Tax Court, (R. 88), may be summarized as follows:

Petitioner Smotkin for many years was a resident of Columbus, Ohio.

In 1944, for reasons of his wife's health, Smotkin retired and moved to Beverly Hills, California. Thereafter he entered the photo-finishing business, which business was terminated in 1948 when he moved to Tucson, Arizona. In 1948 Smotkin formed a partnership with Bromley and with Jay Smotkin (petitioner's brother) under the name, American Homes Association, hereinafter called the partnership. After Jay was bought out in 1949, Smotkin had a two-thirds interest and Bromley a one-third interest in the capital, profits and losses of the partnership (R. 88d).

In February 1948, the partnership purchased an 80-acre tract of land near Tucson, Arizona, and by the latter part of 1949 or early 1950, the partnership had purchased two adjacent 80-acre tracts of land. During the period from 1948 to June 30, 1951, this partnership built and sold approximately 500 dwelling houses on two of the 80-acre tracts, (R. 88d).

The partnership built no homes for resale after June 30, 1951, (Trans.[2] 30).

In July 1951, the partners determined to meet a need for wartime rental housing in Tucson area by the construction of rental duplexes on the third 80-acre tract, (Trans. 18).

In accord with their decision, the partners proceeded, in 1951, to, (R. 88d):

(a) Incorporate American Homes Association as the rental management corporation.

[2] Transcript of Testimony, dated March 2, 1965.

(b) Incorporate American Building Company as the building corporation.

(c) Incorporate six rental corporations to hold the rental property. (American, National, Federal, Joan, Harold and Carole Rentals). The stock in these corporations was issued one-third Bromley, one-third Smotkin, and one-third Bromley as Trustee for Smotkin's children.

Construction was commenced in late 1951, and by July 14, 1952, 194 duplexes (388 dwelling units) had been completed, (R. 88e). Construction financing was obtained through private individuals, the Southern Arizona Bank and Trust Company, Tucson, and the Arizona Trust Company, Tucson. These loans were secured by duplex lots, personal guarantees of the partners and other real estate, including personal residences owned by the partners. The permanent financing was obtained from banks, savings and loan associations, trust and insurance companies. On some of these loans, the personal guarantees of Smotkin and Bromley were required, (R. 88g).

On April 20, 1952, Arizona Trust Company, Tucson, Arizona, took over as successor Trustee from Bromley, the trusts for the benefit of Smotkin's children. The Arizona Trust Company served as Trustee during all of the years here in issue, (R. 88e).

The construction price charged by American Building Corporation to the rental corporations was $12,600.00 per duplex, which sum included coolers, venetian blinds, stoves and refrigerators for each unit. The $12,600.00 figure was also the sum of the permanent mortgage on each duplex. (The $12,600.00 represented 80% of the F.H.A. appraised value). The land was reflected on the rental corporations' books at $200 per duplex lot,

making a total cost of $12,800.00 per duplex, (R. 88g). American Building Company was liquidated in January of 1953, (R. 92).

On January 2, 1952, a management agreement was executed by American Homes and the six rental corporations under which American Homes agreed to manage the 194 duplexes owned by the rental companies, to act as rental and operating agent and collect rentals, to advertise the properties for rental, and to maintain and repair the properties, (R. 93). It was agreed that American Homes would receive a commission of ten percent of gross rentals during 1952, and 20 percent of gross rentals after January 1, 1953, and would pay all expenses in connection with the advertising, leasing, maintenance and repair of the properties, (R. 93).

During 1953, the occupancy rate of the duplexes was about 65 percent, while during the years 1954 and 1955 the occupancy rate was about 72 percent. The financial statements of the rental corporations during the period 1953 through 1955 show substantial and consistent losses. During the first three and one-half months the duplexes were rented, they were rented by written lease agreements. Thereafter, they were rented on an oral month-to-month basis, (R. 94).

In an attempt to increase tenant occupancy, petitioner Smotkin, in January of 1954, proposed a swimming pool be built, and that 120 of the units be furnished. Since the cost of these additions would exceed $120,000.00, and since it would involve personal guarantees and mortgaging of other personal assets, Bromley refused to agree, and Smotkin and Bromley separated by the exchange of assets and cash, (R. 94). After this exchange, ownership of the six rental corporations and American Homes Association became one-third peti-

tioner Edward E. Smotkin, one-third petitioner Betty J. Smotkin, and one-third Arizona Trust Company as Trustee for the three Smotkin children. In the separation agreement, petitioners Edward E. Smotkin and Betty J. Smotkin agreed to indemnify and save harmless from any and all obligations and liabilities in connection with the duplex rental project, including any personal liability on the guarantees made in connection with the Prudential Life Insurance permanent mortgage financing, (Ex. 58).

American Homes Association proceeded, in 1954, to build the swimming pool and purchase furniture for 120 rentals, (Trans. 22). However, the vacancy rate remained high, the rental corporations continued to incur heavy losses and rental income was not sufficient to meet mortgage payments, (Trans. 22).

Early in 1955, Mr. Smotkin's health deteriorated. He developed a heart condition known as paroxysmal auricular tachycardia, which attacks were accompanied by a sudden and rapid heart beat, by lightheadedness, general malaise and anxiety. The attacks would last from 5 minutes to 12 hours. He developed ulcers of the duodenal, and suffered from nervous tension. He was referred to a cardiovascular specialist in San Francisco by his Tucson physician, Dr. Stephens. He was seen by Dr. Stephens twenty-five times during 1955. He was hospitalized in Tucson in the Fall of 1955 for treatment of his ulcer. Both the Tucson and San Francisco doctors concluded, with regard to Mr. Smotkin's health problems, that "business problems are primary," (Ex. 77).

In the Fall of 1955, Mr. Smotkin determined that it was impossible to hold the duplexes for rental, and that it would be necessary to liquidate his investment, (Trans. 26).

On September 1, 1955, the six rental corporations were liquidated and 186 duplexes were distributed to the stockholders in liquidation. The remaining eight duplexes had been sold between June 1, and August 31, 1955. American homes served as selling agent for the stockholders and proceeded as rapidly as possible to sell the duplexes, (Ex. 62). Commencing on or about November 1, 1955, the duplexes were advertised for sale. Prior to that, for over three years the duplexes were advertised only for rent, (R. 95). American Homes employed extensive newspaper and radio advertising as part of its selling efforts, (R. 88i).

American Homes also offered the free use of the pool for a temporary period to a purchaser of a duplex and his tenant. The pool agreements formed a part of the original contracts of sale, (Ex. 73). The books and records of American Homes show that owners and tenants of the duplexes were not charged for pool service until May 1, 1958. A typical pool agreement stated that after a cut-off date the pool privilege would be optional to the owner and his tenants at a specified annual price. After the sale of duplexes and during the years in issue, American Homes acted as rental agent for some of the new owners, (R. 95).

The free rental service was to be provided for a five-year period, and was so provided by American Homes. In addition, American Homes provided free garbage collection service for a limited period of time to owners of duplexes and their tenants, (R. 95-96).

During the period 1955 to 1958, 169 duplexes were sold. The remaining 17 duplexes were exchanged in 1956 for a cattle ranch. Approximately 55 of the duplexes were sold furnished. Most of the duplexes were sold at prices ranging from about $15,000 to about

$16,200. A typical sale would be handled in the following manner:

| | |
|---|---|
| FHA mortgage assumed by purchaser | $11,419.98 |
| Cash down payment | 1,100.00 |
| Contract | 2,710.02 |
| Total sales price | $15,230.00 |

The contract ($2,710.02 in the above example) executed by the purchaser provided for interest of 6 percent per annum and required payments of principal and interest totaling $25 per month, with the entire contract sum due in five years. If the sale involved a furnished duplex, then the contract would require a payment of principal and interest totaling $45 per month, $20.00 of which went to American Homes for the furniture, (R. 96).

In 1956 Smotkin obtained a real estate broker's license as a designated broker for American Homes; such license has been renewed annually to the present time. Smotkin is a member of the National Board of Realtors and the Tucson Real Estate Board, (R. 97).

In the period 1956 - 1962, petitioners reflected on their income tax returns, eleven casual sales of property which in most cases they had held for several years. (Two of the sales involved ranch property traded on several of the duplexes, (R. 97).

In the period June 1951, to September 1955, (the period of holding the duplex rentals) the taxpayers had no real estate purchase or sale activity, (Trans. 30; Ex. 3-7).

Taxpayers on their Federal income tax returns for the years in issue, reported the gains realized from the

sale of the duplexes as long-term capital gains, (Ex. 7-10).

Taxpayers (who were on a cash basis) considered the contracts received by them from the purchasers of the duplexes as having no ascertainable fair market value, and, accordingly, reported the payments on the contracts as income only in the year in which the payments exceeded their adjusted basis.

The Tax Court held that the taxpayers from the very outset were prepared to rent or sell the duplexes, and that at the time of the sale they were held by taxpayers in the ordinary course of their trade or business, citing as its sole authority, *Malat v. Riddell*, 347 F.2d 23 (C.A. 9th), which was then on certiorari to the Supreme Court, (R. 101).

The Tax Court further held that the second contracts received from the purchasers had a fair market value when received equal to 50% of their face value, and that they were includible in taxpayers' taxable income at such value in the year of sale.

## SUMMARY OF ARGUMENT

I. The Tax Court erroneously found that taxpayers, who constructed and held 194 duplexes exclusively for rental purposes, were holding such duplexes for sale in the ordinary course of a trade or business when they determined to liquidate their investment. The evidence is that the duplexes were offered for rental for a period of three years and that the taxpayers finally determined to sell them after incurring substantial and continuous losses. The Tax Court erroneously found that the primary business of taxpayer was selling houses to customers. The uncontradicted evidence is that from 1951 down to the present time taxpayers constructed

no houses (other than the duplexes in question), sold no houses (other than the duplexes in question) and were engaged in a number of other businesses, including the garage and furniture business. While the Tax Court was deciding this case, the Supreme Court decided *Malat v. Riddell,* 383 U.S. 569. The Tax Court failed to follow the direction of the Supreme Court and did not make a determination of whether these duplexes were acquired "principally" for sale, or whether their sale was "of first importance." Instead, the Tax Court concluded that when renting was abandoned (assuming a dual holding of for rent or for sale) they must have been held for sale because taxpayer was in the business of selling houses. This is not the test set forth in *Malat.*

II. In the sale of the duplexes, taxpayers received as part of the consideration, the second contracts of the purchasers. Taxpayers treated the contracts as having no ascertainable fair market value and did not take payments thereon into income until received. The Commissioner had determined that the contracts had a value of 50% of face, and took such sum into income in the year of sale. The only person to testify on this issue, an expert witness offered by the taxpayers, testified that the contracts had no ascertainable fair market value on the dates received. The Tax Court with no supporting factual basis adopted the 50% of face value.

## ARGUMENT

I. THE TAX COURT ERRONEOUSLY DETERMINED THAT TAXPAYERS WHEN THEY DECIDED TO LIQUIDATE A MONEY-LOSING RENTAL INVESTMENT HELD FOR OVER THREE YEARS, WERE (WHEN THEY DETERMINED TO SELL) HOLDING SUCH PROPERTY FOR SALE TO

CUSTOMERS IN THE ORDINARY COURSE OF THEIR TRADE OR BUSINESS.

From 1948 to 1951 Taxpayer Smotkin was an active builder of homes for sale in Tucson, Arizona, (R. 92). Such sales were reflected in his tax returns as ordinary income, (Trans. 43). In 1951, Smotkin and his then partner, Bromley, determined to construct rental duplexes and keep them permanently as an investment, (Trans. 19). They proceeded to construct 194 duplexes for rental purposes, (Trans. 20). The partners decided at the same time to get out of the business of building homes for sale, and as a matter of fact from 1951 down to the present time neither taxpayer Smotkin, nor any of the other taxpayers have built any homes for resale in Tucson, Arizona, or elsewhere, (Trans. 30). From the time of construction of the rental duplexes in 1951 until November 1, 1955, the duplexes were offered only for rent and not for sale, (R. 88i). The F.H.A. Regulations under which taxpayers built, allowed them to build for sale or rent, as they might choose, (Trans. 31). Their choice was to rent all of them.

The rental program was not successful. In spite of heavy borrowings for the construction of a swimming pool and the furnishing of 60 duplexes, the occupancy rate remained at the sixty to seventy percent level, (Trans. 22). From 1952 to 1955, the rental corporations suffered losses in excess of $162,000.00, (Ex. 46). In addition, American Homes Association, the rental agent, during the same period suffered losses in excess of $100,000.00, and it was engaged in no other business activity, (Ex. 35-38). These business reverses led to a breakdown in taxpayer Smotkin's health, (Trans. 25; Ex. 77). The taxpayers, under these conditions, found it impossible to retain the duplexes for investment purposes, and they entered into a program of liquidation,

(Trans. 26). Once they determined to liquidate, the duplexes were sold as rapidly as possible, and in the period from the middle of 1955 to August of 1957, the duplexes were sold, (Ex. 62). Since 1957, taxpayer Smotkin has been in the garage and furniture business and the rental of commercial frontage and stores, (Trans. 33). It was not until 1956 that American Homes Association, the selling agent, obtained a broker's license. None of the taxpayers held a broker's license except Mr. Smotkin, who had held one for a short while in Columbus, Ohio in the early 1940's, (Trans. 29).

Based upon these facts, the Tax Court held in its memorandum opinion filed November 18, 1965, that: "the sales of the duplexes in the years in issue did not represent the liquidation of an investment as contended by the petitioners, but instead were sales of property in the ordinary course of business." (R. 99).

The Tax Court reached this legal conclusion from their finding that: "from the very outset petitioners were prepared to either rent or sell these 194 duplexes whichever proved the most profitable course of action . . ." (R. 101). This finding then brought the case, in the Tax Court's view, in full accord with *Malat v. Riddell,* 347 F.2d 23 (C.A. 9th), which was the only case it cited or quoted, (R. 101). At the time of the Tax Court's memorandum opinion of November 15, 1965, certiorari had been granted in *Malat,* (R. 101). Certiorari was granted to resolve a conflict between the various Circuit's interpretation of the word "primarily" as used in Section 1221. (See *Municipal Bond Corp. v. Commissioner,* 341 F.2d 683 (C.A. 8th).

Appellants moved the Tax Court to postpone entry of decision pending Supreme Court action which was promptly denied, and on March 18, 1966, decision was

entered. The Supreme Court entered its decision vacating and remanding *Malat* on March 21, 1966. (383 U.S. 569) On June 6, 1966, the Tax Court in the instant cases filed a supplemental memorandum findings of fact and opinion, (R. 112). In its supplemental memorandum the Tax Court affirmed its prior conclusion and sought to explain the legal standard used in arriving at its conclusion. It first attempted to distinguish factually the instant cases and *Malat* by saying that in the instant cases, the taxpayers' "business was primarily the development of tracts of realty for sale to customers in the ordinary course of its business," while in *Malat* the partnership, "for some time had been engaged in the purchase and development of real estate for rental." (R. 114). It went on to say that when speaking in its original opinion, that these taxpayers intended at the outset to rent or sell, it had in mind a taxpayer whose primary business was developing houses for sale, (R. 114).

The Tax Court's conclusions in these cases are clearly erroneous, factually and legally. The Tax Court's interpretation of *Malat* is in error both factually and legally.

Against an overwhelming sum of contrary evidence there are two facts that the Tax Court relies on in concluding that in the duplex sale period, 1955 through 1957, taxpayers were in the primary business of developing houses for sale.

The first of these facts is that taxpayers at the outset intended to rent or sell, whichever proved the most profitable, (R. 101), and this is alleged to be proved by the fact that the 1952 application taxpayers filed for F.H.A. mortgage insurance on the duplexes, (Ex. 56), contained the following question and response: "Do

you intend to occupy, rent or sell this property?" The taxpayers answered the question, "rent." Part of the same question, which asked for the proposed sale price, (if for sale), taxpayers gave a price of $15,750.00. We have attached a copy of this document to the appendix, (Exhibit 56DDD, Appendix, infra). We believe that the most that can be said for this document is that it is inconclusive as showing any specific intent to rent or sell. Under these circumstances we think the document's real meaning, and the taxpayers' intent, must be found in other evidence. The other evidence is:

(a) That the duplexes were offered only for rent for a period of three years. They were not offered for sale until the liquidation began in the Fall of 1955, (R. 88i.)

(b) Not one duplex was sold until almost three years after renting commenced, (Ex. 62).

(c) A rental management contract was entered into between American Homes Association and the rental corporations, (R. 88h).

(d) Taxpayers spent, during the rental period, $120,000 on a swimming pool and the furnishing of 60 duplexes, (Trans. 22, 23). Surely no one whose true intent was to sell would, in the middle of the rental period, invest $120,000 in a pool, and furniture for tenants.

(e) The taxpayer's own testimony, that he intended to quit building houses for speculation and to build these rental duplexes for retirement income, (Trans. 19).

(f) A real estate broker's license was not obtained by taxpayers, or any of their corporations, until 1956 after liquidation began, (Trans. 29).

(g) The determination to sell the duplexes was based upon factors not present when they were first rented three years earlier, and when the duplexes were finally sold there existed excellent reasons for such sale:

(1) Business: losses in the rental corporations of over $162,000, (Ex. 46). Losses in the rental management corporation of over $100,000, (Ex. 35-38).

(2) Personal: The deterioration in Mr. Smotkin's health, (Trans. 25; Ex. 77).

The other fact emphasized by the Tax Court in its supplemental memorandum is that in years prior to the construction of the duplexes, taxpayers had built and sold some 500 houses. From this they concluded: "the ultimate sales during the years in question can well be said to be within the every day operation of a business that was primarily selling houses to customers," (R. 114). The overwhelming contrary evidence is:

(a) During the period 1948 to June 30, 1951, taxpayer Smotkin did build and sell approximately 500 houses, but he testified that commencing in 1951 he intended to quit building houses for speculation, and to build the rental duplexes for retirement income, (Trans. 22).

(b) The evidence shows that except for the duplexes in question, the taxpayers, or any of their corporations, did not build or sell one house from the period June 30, 1951, down to the time of the trial of this case. They did not build or sell any houses during the duplex rental period, 1952 - 1955, (Trans. 30). They did not build or sell any houses during the liquidation period 1955 - 1958, (Trans. 30). They did not build or sell any houses in the post liquidation period 1957 - 1965, (Trans. 30). Surely these facts cannot possibly

lead to a conclusion that this was "within the everyday operation of a business that was primarily selling houses to customers."

(c) Subsequent to the duplex liquidation, American Homes Association was engaged in the construction of commercial rental property, Mr. Smotkin was engaged in the rental of commercial property, the garage business, the furniture business and the auto parts business, (Trans. 33, 40).

(d) Paragraphs (f) and (g) above, are also pertinent to this issue.

We believe these facts clearly show that the primary purpose for building the duplexes was for rental purposes and that the sale some three years thereafter was not inconsistent with this original purpose. Except for the two facts noted above, which are as we have stated most inconclusive, there is not one document or word of testimony to support the Tax Court's finding that taxpayers' everyday business was selling houses.

We believe the instant case is squarely within the language of this Court, when in *Malat* it stated, 347 F.2d 23, at 26, (C.A. 9th): "In such a case as this the purpose of the holding is undoubtedly difficult of ascertainment, *where an investment program has been followed through it is there for all to see.*" [Emphasis supplied]. See also *Palos Verdes v. U.S.*, 201 F.2d 256 (C.A. 9th).

In spite of the contrary evidence, if it is assumed *arguendo* that the Tax Court was correct in its finding that the primary business of these taxpayers was the development and selling of houses, it failed to apply the correct legal standard to this finding. The Tax Court stated, (R. 114):

> "When we say in our opinion that petitioner intended at the outset to either rent or sell these houses, whichever proved more profitable we are talking of a taxpayer whose primary business was developing and selling houses and who was about to rent some of its houses, and if renting proved unprofitable then it would be abandoned as a business endeavor and the houses . . . would be held primarily for sale. . . ."

This of course is not the issue. The issue is for what purpose were they holding these particular duplexes and was that purpose their primary purpose. *Malat v. Riddell,* 383 U.S. 569. It is not enough for the Tax Court to say that they were in the business of building and selling houses, that they built these duplexes to sell or rent, and that when they determined to sell, it became their primary purpose, and thus was in the ordinary course of their trade or business. Under the Tax Court's reasoning, these duplexes could never be sold as the liquidation of investment property —— even if they were held for rent for 30 years. Its reasoning is that since taxpayers' primary business was building houses, and they built these to rent or sell, when they abandoned the rental, selling by some magic becomes the primary purpose. This is not the law. If it were, a homebuilder could never hold houses or duplexes for investment. The essential findings never made by the Court, were those findings necessary to support its legal conclusion that *these duplexes* were primarily being held for sale. To arrive at this conclusion the Tax Court would have had to find that when the duplexes were constructed, taxpayers had a dual purpose (renting or selling), but that selling was their primary purpose. This they could not possibly find because of the uncontradicted evidence of renting for three years.

The Tax Court committed further error when it stated in its supplemental memorandum:

> "We think the houses in question were being held *after* late 1955, for sale to customers in the furtherance of the primary business purpose of the petitioner, which was that of developing real estate and selling houses." [Emphasis supplied.] (R. 115)

The critical event is the purpose of the holding, and it is not the actual sale which governs. *United States v. Bennett,* 186 F.2d 407, 410-411, (C.A. 5th); *McGah v. Commissioner,* 210 F.2d 769 at 772, (C.A. 9th); *Municipal Bond Corp v. Commissioner,* 341 F.2d 683, 689 (C.A. 8th).

3B *Mertens Law of Income Taxation,* § 22,138, ¶ 628-629, states the rule as follows:

> "If the taxpayers' situation is examined at the very moment the property is sold, it will invariably be found that there was an intent to sell, but such literal approach would nulify the statutory provisions conferring capital gain or loss treatment, and would seem to go beyond the legislative intent behind the exclusion involved."

The Tax Court's undue emphasis on taxpayers' 1948-1951 activity of building and selling single dwelling houses creates doubt as to whether the Court understands that not only can a taxpayer be previously engaged in holding property for sale to customers, and yet have investment property, but he can also hold property for sale at the same time he holds other property for investment. The Tax Court itself has recognized this rule many times. In *Municipal Bond Corp. v. Commission,* 46 T.C. 219 (on remand from the Eighth Circuit and pursuant to (*Malat*), it stated, (46 T.C. 219, ):

> "Petitioner is a corporation whose sole business activity over a number of years has apparently been

> buying, holding, renting and selling real estate. While we recognize that a corporation may be an investor in real estate entitled to capital gains on the profits realized on the sale of such investment property, see *Randolph v. Rouse*, 39 T.C. 70. . . ."

The Rouse case cited by the Tax Court above, was acquiesced in by the Commissioner, (1963-2 Cum. Bull. 5). *Rouse* involved a taxpayer who was a developer and builder of houses for sale. In the years 1950-1953 he acquired from his building corporations some 40 houses which he held for rent. When the rental market deteriorated, he sold them in 1953, 1954 and 1955. The Tax Court in holding that he was entitled to capital gain on the sale, stated, (39 T.C. 70, 76):

> "On the facts here there can be little question but that petitioner purchased and held the 40-odd houses in the Great Forest and Bel Air subdivisions for investment and rental purposes, as we have found above. The fact that he rented most of them for periods of 2 years or more; *that he decided to go out of the rental business only after changes in real estate conditions made it unprofitable;* that he purchased no more houses for rent after that time; that he offered none of his houses for sale as long as he could rent them satisfactorily; and that the sale of the rental houses extended over a period of several years, as tenant occupancies failed, all tend to support petitioner's contentions that he acquired and held houses for rental purposes and not for resale. The record contains little evidence in support of the contrary view. The gains on the sales of the properties that were held for 6 months or more were property reported, we think, as long-term capital gains." [Emphasis supplied.]

In *D. G. Bradley v. Commissioner*, 26 T.C. 970, the Tax Court held that a person who was both an investor and dealer in real estate was not a dealer in real estate when he sold 24 houses in 1948 that he had built in 1946

and rented between 1946 and 1948. The Court stated he had valid reasons to sell in order to pay the expenses of his wife's illness, and to transfer his investments to a motel and dwelling units in Arizona. The Court stated, (26 T.C. 970, 979):

> "The facts indicated to our satisfaction that his decision to sell was based on these factors and that prior to the sales he was holding the property in question for rental investment purposes. The sales were incident to liquidation in order to transfer his holdings to other types of investment and to relocate in Arizona. Walter R. Crabtree, supra. The fact that his income from sales was greater than his income from rentals does not mean that all property sold was primarily for sale in the ordinary course of trade or business. Cf. Delsing v. United States, (C.A. 5, 1951) 186 F.2d 59, 61)."

In *Curtis Company v. Commissioner,* 232 F.2d 167 (C.A. 3rd), petitioner built, in 1944, 1098 units for rent. In 1946, the restrictions on their sale were removed and in 1947 he sold 851 units and the balance were sold in 1948 and 1949. The Court in holding that petitioner was entitled to capital gain stated, (232 F.2d 167, 169-170):

> "Is the taxpayer any worse off because it did the selling itself and by single parcels instead of job lots? We do not see how it can be fairly said so. With the concession that up to the very minute of decision to get out of the housing rental business the property was held for investment and with the undisputed fact that after the rental properties were sold the taxpayer turned its attention to other activities, we do not see that there is basis for saying that the regular course of its business, as to these houses, was real estate selling. We think it a case of one having an investment property on hand which he wants to turn into another form of investment. By the very nature of the case he had to sell the properties a piece at a time. Surely that does not make

> him a 'dealer' in these parcels of land any more than it would make a man a dealer if he wanted to liquidate his holdings in a corporate stock for which the market was weak so that he had to sell by small parcels instead of by one sale. That is the taxpayer's situation here."

It would appear that the Tax Court is in conflict with itself in its undue emphasis of the prior building activities of taxpayer Smotkin, which building activities ended four years prior to the years in issue.

In summary, we would say that the Tax Court's conclusion that these duplexes were "being held after late 1955 for sale . . . to customers in furtherance of the primary business purpose of the petitioner, which was that of developing real estate and selling houses" was not a finding drawn from the evidence, but one induced by an erroneous view of the law.

## II. THE TAX COURT ERRONEOUSLY DETERMINED THAT THE SECOND CONTRACTS RECEIVED BY THE TAXPAYERS FROM PURCHASERS OF THE DUPLEXES HAD AN ASCERTAINABLE FAIR MARKET VALUE.

Taxpayers received in the sale of the duplexes, second contracts payable $25.00 per month ($45.00 per month furnished), including interest, with the total sum due in five years. (The face amount of the second contracts was from approximately $1,800.00 to $4,000.00). They treated these as having no ascertainable fair market value, and did not take payments thereon into income until such payments were actually received. The Commissioner and the Tax Court determined that the contracts had a value of fifty percent of face, and took such sum into income in the year of sale.

Section 1001(b) of the Internal Revenue Code of 1954, provides in part as follows:

"(b) AMOUNT REALIZED — The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

In *Johnston v. Commissioner,* 14 T.C. 560, the Tax Court held that a cash basis stockholder who received a contract for the sale of his stock in 1942 could not report the gain on his sale in 1942, but must report that gain in 1943, when the contract was paid off. The Court determined that he realized no gain on his sale until the amount realized exceeded his basis [citing *Burnet v. Logan,* 283 U.S. 404], and that the contract was not an "amount realized". The Court stated:

"An agreement, oral or written, of some kind is essential to a sale. If payment is made at the same time that the obligation to pay arises under the agreement, then the profit would be reported at that time no matter which method was being used. However, the situation is different when the contract merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which would be recognized as the equivalent of cash to some extent, are given and accepted as a part of the purchase price. That kind of a simple contract creates accounts payable by the purchasers and accounts receivable by the sellers which those two taxpayers would accrue if they were using an accrual method of accounting in reporting their income. But such an agreement to pay the balance of the purchase price in the future has no tax significance to either purchaser or seller if he is using a cash system." 14 T.C. 560 at 565.

Petitioners received no notes, mortgages or other evidences of indebtedness, (Trans. 33).

In *Ennis v. Commisisoner,* 17 T.C. 465, the Court determined that where property was sold under a con-

tract providing for a cash down payment and deferred payments over a period of years (not evidenced by a note or other evidence of indebtedness), the contract was not equivalent to cash and the only amount realized by the taxpayer in the year of sale was the sum of cash received. The Court stated, 17 T.C. 465, at 470:

> "In determining what obligations are the 'equivalent of cash' the requirement has always been that the obligation, like money, be freely and easily negotiable, so that it readily passes from hand to hand in commerce."

See also *Mertens Law of Federal Income Taxation*, Vol. 2, (1961 Revisions), § 11.05; 11.06.

In *Phillips v. Frank*, 295 F.2d 633, (C.A. 9th), this Court recognized the rule of the above cases.

The Tax Court's memorandum findings of fact and opinion cites no cases in support of its view that the second contracts had an ascertainable fair market value and that such value was 50% of the face. The Commissioner at the trial of this case offered no testimony expert or otherwise on value.

The only expert to testify was offered on behalf of the taxpayers, he was a well-qualified, (Ex. 79), M.A.I. appraiser. He testified as follows, (Trans. 59):

> "Q. Now, based upon your experience in this field and your examination of those sample contracts and the testimony here today, do you have an opinion whether or not these contracts would have been on the dates received freely and easily negotiable in Tucson, Arizona?
>
> A. Yes, I have such an opinion.
>
> Q. What is that opinion, sir?
>
> A. That these contracts were not negotiable and that they were not freely and easily negotiable

and they would not readily pass from hand to hand in commerce.

Q. Would they on the dates received have had an ascertainable fair market value?

A. No, sir, not in my opinion."

This was the only evidence before the Court on this issue. If, in fact, these contracts did have an ascertainable fair market value, or were readily negotiable in Tucson, Arizona, the Government could have called any number of Title Officers, Appraisers, Bankers or other persons qualified to so testify. *They did not do so.*

The weight to be given such evidence is set forth in *Roth Equipment Co. v. Gallagher*, 172 F.2d 452 (C.A. 6th), at page 455:

> " . . . The only direct evidence before the Court on the specific question of reasonableness of compensation was the testimony of Harold Hampton and Archie Shearer, both well-qualified, impartial witnesses, with many years of experience. They testified that in their opinion the compensation was reasonable, with Mr. Hampton referring to it as 'very reasonable'. The credibility of these witnesses was not put in issue. The appellee offered no witness to contradict this testimony or to testify in any way that the compensation was unreasonable to any extent. On this crucial and single issue of fact in this case this unimpeached, uncontradicted testimony from well-qualified, impartial witnesses can not be disregarded by the Court. This Court has several times stated that such testimony should be accepted by the fact-finder in a matter in which the fact-finder has no knowledge or experience upon which he could exercise an independent judgment. [citing cases] . . . "

There is no question that these contracts would not move freely and easily in commerce when consideration is given to the inducements given to purchasers which

endured beyond the sale date, such as free rental service for an extended period, free pool service and free garbage service, (R. 881; Ex. 73, 74). American Homes Association, as selling agent for the taxpayers offered the inducements and signed the Deposit Receipt and Sales Agreements with the purchasers, (Ex. 65, 69). There is no question that the obligation to fulfill these free services would attach to anyone who purchased the second contracts. It is a fundamental propostion of agency law that an agent's acts within the scope of his authority are the acts of the principal. Such authority may be confirmed by actual authority, implied authority and also from conduct, as stated in 3 Am. Jud. 2d, § 73 (p. 475):

> "The liability of the principal for acts and contracts of his agent is not limited to such acts and contracts of the agent as are expressly authorized, necessarily implied from express authority, or otherwise actually conferred by implication from the acts and conduct of the principal. So far as concerns a third person dealing with an agent, the agent's 'scope of authority' includes not only the actual authorization conferred upon the agent by the principal, but also that which has apparently been delegated to him."

It is, therefore, apparent that the pool agreements signed by American Homes Association at the time of the signing of Deposit Receipt and Sales Contracts were fully binding upon taxpayers.

The expert witness testified on cross-examination (over objection of taxpayers' counsel) as follows, (Trans. 66):

> "Q. Mr. Klafter, if I were to offer you that particular contract to buy, in other words, I offered to sell it to you, based upon your examination of these duplexes and of the property and without telling you that there are any other conditions out-

side the scope of this contract, would that contract be marketable? Would you be interested in buying it?

Mr. Ritcher: I object, Your Honor. It's a hypothetical question. It assumes facts are not in evidence which are in evidence.

Judge Mulroney: This is cross-examination. The Court allows the utmost latitude in cross-examining an expert. He may answer.

A. I would be interested in buying it only at a discount, not for face value."

From this improper question which asked the witness not to consider facts which were in evidence the Court was able to conclude that the contracts were marketable. The question became meaningless and irrelevant when the witness is asked to ignore conditions which in fact existed. It would be similar to asking a witness to value a contract which provided for interest only and no payment of principal for 20 years with the qualification that the witness was to ignore the absence of principal payments.

The error was further compounded. The witness was asked the price which *he* would be willing to pay for these purely hypothetical contracts. He stated that every contract would have to be valued on an individual basis and it would depend on a large number of individual factors including the purchasers' earnings, his equity, the price he paid, (Trans. 67). From this the Court was able to conclude that this large number of second contracts could have been sold in Tucson, Arizona, for 50% of their face value! The fact that this witness testified that he might buy a contract after investigation of the individual purchaser can not establish that there was an ascertainable market for 194 of the contracts in Tucson, Arizona.

Finally to buttress its conclusion the Tax Court adopts a negative inference based upon hindsight — it states, (R. 103):

> " . . . and, finally, there is no indication that the payments on these contracts (which had to be paid in full within a five year period) were not generally made as required."

This Court's case of *Phillips, et al. v. Frank*, 295 F.2d 629 (C.A. 9th) deals with a slightly different issue, but the language of the conclusion there seems most appropriate to the instant case, (295 F.2d 629, 633):

> "There is no evidence in the record that such rights had any market value, fair or unfair . . . "

## CONCLUSION

The decisions of the Tax Court are erroneous and should be reversed.

Respectfully submitted,

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I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

____________________

DAVID W. RITCHER
Attorney

## EXHIBITS

| *Number* | *Identified* | *In Evidence* |
|---|---|---|
| 1 - 77 | Received by Court with Stipulation of Facts (R. 15) | |
| 78 | 28 | 29 |
| 79 | 58 | 58 |
| 80 (zzz) | 76 | — |
| www | 44 | 46 |
| xxx | 68 | 71 |
| yyy | 70 | 71 |

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**APPENDIX 56DDD ATTACHED**